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CURRENCIES AND CREDIT MARKETS

No.201/ January, 1990

As man may suffer from many ills and yet, for an indefinite time, lead a vigorous life without being seriously inconvenienced until his general vitality has ebbed away; so the economic organism may bleed from many wounds, which it bears lightly, in three out of four cyclical phases.

Business Cycles, Joseph A. Schumpeter, p.911

HIGHLIGHTS

For the U.S. dollar, the support of a substantial interest rate differential is absent for the first time in 15 years. But compared to that earlier time in the 1970s, there now are some disquieting differences.

Today, a huge current account deficit lumbers the whole U.S. economy, its financial markets and its currency with an addictive dependency on an uninterrupted inflow of foreign capital. Such an inflow must be maintained just to offset the external deficit.

The central bank of a country with a large external deficit is always free to tighten but never free to ease without constraint. Having entered the 1990s under such conditions, market participants in the deficit countries had better bear this asymmetry in mind.

It is Western Europe that enters the 1990s with a new dynamism. In contrast, America limps into the new decade hobbled by the lowest growth potential of the entire post-war period. And it does so with an extremely vulnerable and fragile financial system.

Potential for U.S. productivity growth remains as poor as ever. A likely growth rate of 1% taken together with a slower labour supply expansion, implies a long-term growth limit for the economy of little more than 2.5%. Neither U.S. policy makers nor markets are prepared for the lowest growth ceiling among industrialized nations.

Surely, America stands at a critical threshold. Can that point be very far when the smoke of "never-say-die" optimism finally blows away to reveal the jagged weakness of underlying economic and financial realities that have been lurking all along?

Efforts to keep the U.S. ship afloat are competing against time and ever larger leaks in the superstructure. There's a deluge of life-threatening seawater everywhere including a riddled financial system, ebbing profits and swooning real estate values.

The Fed is certain to come under increasing pressure to ease. The Fed may resist, but we even doubt that such a show of determination would be enough to stabilize the dollar. Once confidence has been shattered, foreign investors will demand higher interest rates.

For the real economy, higher rates will be devastating. Financial markets will be bludgeoned with two clubs: the illiquidity caused by the vacuum of capital outflows and the waning fundamentals of a weakening economy.

THE DOLLAR: UNSTEADY AS THE LOWER SHE GOES.

Entering the New Year, we are struck by the counterpoise of two series of world events: the jubilant crowds atop the Brandenburg Gate on New Year's Eve and the glowing financial reports that continue unabated from the media and Wall Street over prospects for the U.S. economy.

Furtively, but ever so cavalierly, the warm glow is spread far and wide. To quote Alan Abelson of Barron's commenting on institutional investor psychology: "*In their hearts, they are bullish ... although they pull a grave face and affect a sober tone, as only befitting fiduciaries with the weight of their BMW payments on their shoulders. They are really bubbling with optimism. Once you get them gabbing, the mask drops and they all but leap into the air with elation over the prospects for peace, prosperity and capital gains.*"

Even economists - who supposedly shouldn't be prone to the vagaries of the day - have not escaped the communicable virus of terminal optimism either. The National Association of Business Economists reported that 62% of its members are expecting no recession within the next three years. As the president for the organization puts it: "*We never ever had such an overwhelming majority forecasting growth over three years.*"

Apparently economists and Wall Street aren't alone in their upbeat perspective. Consumer confidence still remains high by historical standards even though the manufacturing sector - judging by sharply lower profits and the extended weakness in new orders and production - looks like it's teetering on the brink of recession. Business executives brim with positivism and confidence. The National Association of Purchasing Managers, which represents 250 of the largest manufacturers in the country, states in their semi-annual report a forecast for 3.4% economic growth and low inflation of 1.6% for 1990.

A strange contradiction, though, is that a large majority of these purchasing managers expressed worries over a possible recession, as well as the high costs of credit and health care. By all appearances, wishful thinking got the upper hand in their annual forecast.

ALL BRAVADO WITH NO ROOTS

Given this brave display of optimism in the face of unprecedented economic and financial problems, we have scrutinized numerous reports in order to disentangle some objective and rational reasoning behind this generally cheerful assessment of the U.S. economic outlook.

We just can't find any credible justification for this "never say die" attitude. The explanations that are offered are either terribly vague, superficial or inconsistent, and show a flagrant disregard of the obvious financial and currency problems.

...As Always, An Unquestioned Reverence for the Mystical Powers of the Fed. A main assumption underlying the undying optimism is that the Federal Reserve has the real economy and the financial system well under control. The only concession to reality is the admission that the worst that might happen is a short and shallow recession. But even that is seen to have many salutatory implications. A consequent lowering in inflation, interest rates and imports levels (contributing to a reduced trade deficit) is expected to give the Fed ample room to ease. Voila, the economy is on a rebound again.

The above scenario is a bewitching fairy tale that's even entrancing many economists - particularly those in the Wall Street cauldron. The brew of a sluggish economy and a recession-averting monetary easing is supposed to bring the enrichments of roaring bull markets in stocks and bonds. Long-term bond yields of 6-7% and a 5,000 target level for the Dow Jones Industrial have become widely held forecasts.

The Worst Shall be Best. What will happen if the economy weakens more than expected? The usual cheerful answer is that there's no reason to worry. Never mind that a sharp slowdown is sure to hurt business profits. In this view, what counts more than anything else is that the threat of a recession would prompt aggressive cuts in U.S. interest rates by the Fed. A steep drop in interest rates, by helping revive the economy rapidly and avoiding any financial difficulties, is supposed to offset any drop in earnings. Concern over inflation is then expected to quickly evaporate.

Apparently, any additional easing that would be caused by unexpected economic weakness has to translate into another rampant bull market for U.S. bonds and stocks. In other words, the excess money created by the Fed, will have no other route to go than to Wall Street. And since this bull market would be liquidity-driven, deteriorating business profits do not matter.

TACKLING THE CONSENSUS VIEW: LOWER LONG-TERM RATES

The sunny vista of a further preemptive easing by the Fed enjoys great popularity among commentators. The only snag is that this outlook rests on assumptions and propositions that are either dubious or grossly flawed. Among those are the following:

1. The Fed has ample room to lower interest rates and expand liquidity if necessary and can do this independent of other countries;

2. A monetary relaxation is guaranteed to have its desired stimulative effect on the economy. Many pundits already think that the worst of the economy's slowdown is over and that the past easing has set the stage for a recovery in the second half of this year;

3. The U.S. dollar is not in jeopardy. Despite all the knowing talk about "globalized financial markets", most forecasts of sharply falling U.S. interest rates make no reference to the dollar.

   Those who are mindful of currency aspects, gloss over any concern maintaining that the dollar will hold its own due to the increasing support of fundamentals. Improving U.S. inflation, trade performance, and the avowed resolve of the Fed's-inflationary stance are among these so-called improving fundamentals.

So much for the publicly advertised view. What we hear in our travels, though, suggest that there is a weighty but silent minority - including many on Wall Street - who think otherwise. These individuals are convinced that the U.S. economy and its financial system are clearly drifting into unprecedented economic peril.

Now to defend our earlier comment that the rosy vista is a product of vague and grossly flawed assumptions.

The Long Arm of the Fed in a Straight Jacket? How much room does the Fed really have to fight a threatening recession? Contrary to the voice of many optimists, we see very little. Constraints come from two sides: an inflation rate still hovering in the 4.5 % range and a vulnerable dollar.

Actually, the proof of an inflation constraint on monetary policy has been plain to see. It's only a figment of Wall Street's wishful view to think that 4.5 % inflation rate is low enough to allow unrestrained monetary ease. Obviously, that is not the view of the majority within the Fed. If that were not so, the Fed would have eased much more aggressively in the past months, given all of the overwhelming evidence of a weakening economy?

The Bond Market is Losing Friends. A progressive monetary easing against the backdrop of the present inflation rate wouldn't be to the liking of bond investors. Consider the fact that the lowering of the Federal funds rate from 9.75% to the present 8.125% since mid-year has not benefitted long-term bond yields very much.

Foreign investors have been brutalized with the flat bond market performance since that trend coincides with a steep fall of the dollar against the DM-bloc currencies. As such, foreign investors - particularly European investors - have suffered staggering losses on their dollar-bond portfolios.

Quite frankly, to us, Wall Street's complacency over the U.S inflation trend is an absolutely inexplicable mystery. When one realizes that a strong dollar and a large trade deficit have helped contain U.S. inflation, the inflation performance must really be recognized for what it is: . . . miserable.

U.S. INFLATION DEEPLY MIRED

Wall Street, of course, likes to focus on the beneficial effects of economic weakness on the inflation rate for obvious reasons. However, such relief is temporary at best and comes at the expense of business profits. What really counts in the long run, though, is labour costs and productivity growth. And both of these factors are clearly worsening in the United States. While wage inflation is drifting up, productivity growth has lapsed, resulting in a rising unit labour cost trend.

Looking at cost developments, it becomes apparent that the currently high inflation rate in the United States is not just the result of some temporary cyclical factors. A high inflation rate is also deeply embedded in the unproductivity of the service sector which accounts for over 50% of all consumer spending. (See three graphs on the next page).

A WEAK DOLLAR PREEMPTS MONETARY POLICY

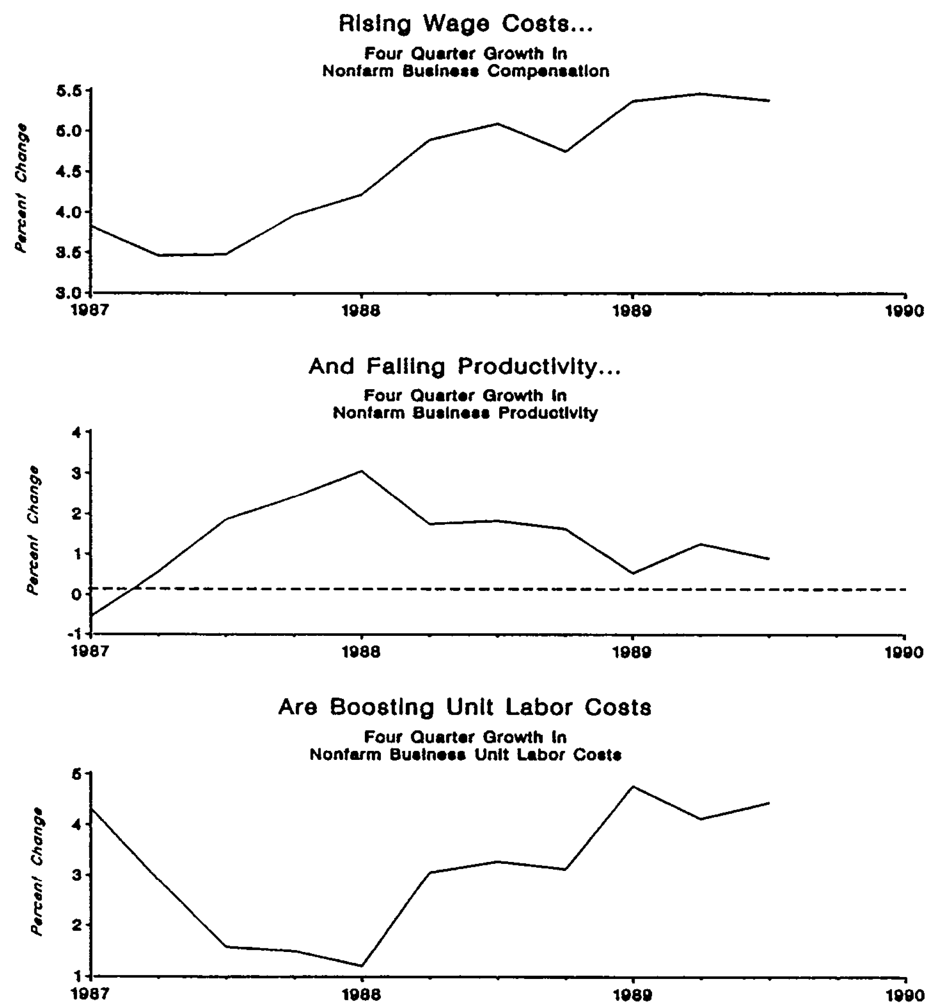
As mentioned earlier, the consensus view is that the Fed will cut short-term interest rates further and that long-term rates are bound to follow suit. That is a presumptuous view. Last year's experience should serve as a reminder that there doesn't have to be a very tight link between short and long-term rates. One recalls that the two rates actually moved in opposite directions during the first half of 1989. While Fed funds soared from 8.5% to 9.75%, long-term government bond yields fell from over 9% to just below 8%.

A Weak Interest Rate Link. . . To us, it seems pretty certain that the extraordinary buoyancy of the U.S. bond market during the first half of 1989 owed a lot of its strength to the surge of the dollar during that period. Conversely, it must also be true then that a declining dollar will have bearish implications for the U.S. bond market. In fact, we think that relationship could turn out to be the main story affecting U.S. financial markets in early 1990.

. . . And No Currency Support. With the first concern of still-high inflation, a second major constraint on U.S. monetary policy is the softening dollar. A falling dollar combined with the trio of acute recession fears, an easing monetary policy and heightened inflation concerns is a dreadful mix to reckon with. In that situation, the Fed would eventually have to jack up interest rates to stabilize the currency and the financial markets. A weak economy then would only be a secondary concern. Such a scenario has plenty of precedents in the United States and elsewhere.

DEUTSCHE MARK STRENGTH: IS IT EUROPHORIA OR RATE SUPPORT?

Eerily, one thing is clear so far: the dollar's sharp fall against the D-Mark has been greeted with surprise but little sign of any anxiety. The general inclination has been to brush off



Source: Drexel Burnham Lambert, ECONOMICS, Dec. 7,89

dollar-weakness purely as a result of DM-strength, which itself is explained as a one-time function of Europhoria and the opening of Eastern Europe. No one is inclined to interpret any internal negative influences for the dollar. Nevertheless, the speed of the dollar's fall makes one wonder what could happen should complacency over the U.S. economy and confidence in the Federal Reserve ever get shaken.

Interest Rate Differentials: Do They Count? Europhoria over East Europe may be a convenient explanation, however, it is inadequate and misleading. The most obvious, most immediate and most natural cause of the D-Mark's strength is hardly ever mentioned: namely interest rate spreads. The short-term interest rate differential between the United Sates and Germany has narrowed sharply and in fact has even reversed. "Euro" three-month deposit differentials have swung from almost 400 basis points early last year (in favour of the dollar) to 20-30 points in favour of West Germany. If anything, given the risk of a U.S. recession, further cuts in the Federal funds rate appear likely.

A reversal in interest rate differentials is even more pronounced against other European

countries. For details on other countries please see the following table comparing interest rate differentials of early 1989 and most recently.

Of those countries that are major factors in international capital flows, only Japan has lower interest rates than the United States. Nonetheless, the differential between these two countries has also narrowed drastically from 4.54% to the present 1.40%. We've been amazed to observe how few people are aware of these dramatic changes in interest rate differentials, though its bearing on exchange rates is obviously crucial.

SHORT-TERM INTEREST RATE DIFFERENTIALS AGAINST THE U.S. DOLLAR

(Three-Month Rates)	Early 89	Early 90
Germany	-3.80	0.10 %
Belgium	-1.80	2.10 %
Netherlands	-3.37	0.50 %
France	-0.73	3.29 %
Switzerland	-4.35	1.00 %
Japan	-4.54	1.40 %
United Kingdom	3.50	6.30 %
Canada	1.53	3.63 %

INTEREST RATES AND THE DM/U.S. EXCHANGE RATE

It has been a long time since West German interest rates exceeded U.S. interest rates. One has to go back to the early 1970s to find a similar occurrence. At that time, the combination of recession in the United States and booming economic conditions in Germany and Europe prevailed. The immediate result was the dollar's first steep decline. Ever since 1974 - except for an extra-ordinary and brief period in 1980 - the dollar has enjoyed the support of a substantial interest rate advantage against D-Mark.

For the first time in 15 years, as the chart on the next page illustrates, the dollar is without the benefit of a favourable interest rate differential.

There are some stark differences this time, though. In the early 1970s the U.S. current account showed a small surplus. Today, a huge current account deficit lumbers the whole U.S. economy, its financial markets and its currency with an addictive dependency on an uninterrupted inflow of foreign capital. Such an inflow must be maintained just to offset the external deficit. Any lesser rate of inflow would be certain to cause discomfiting choices.

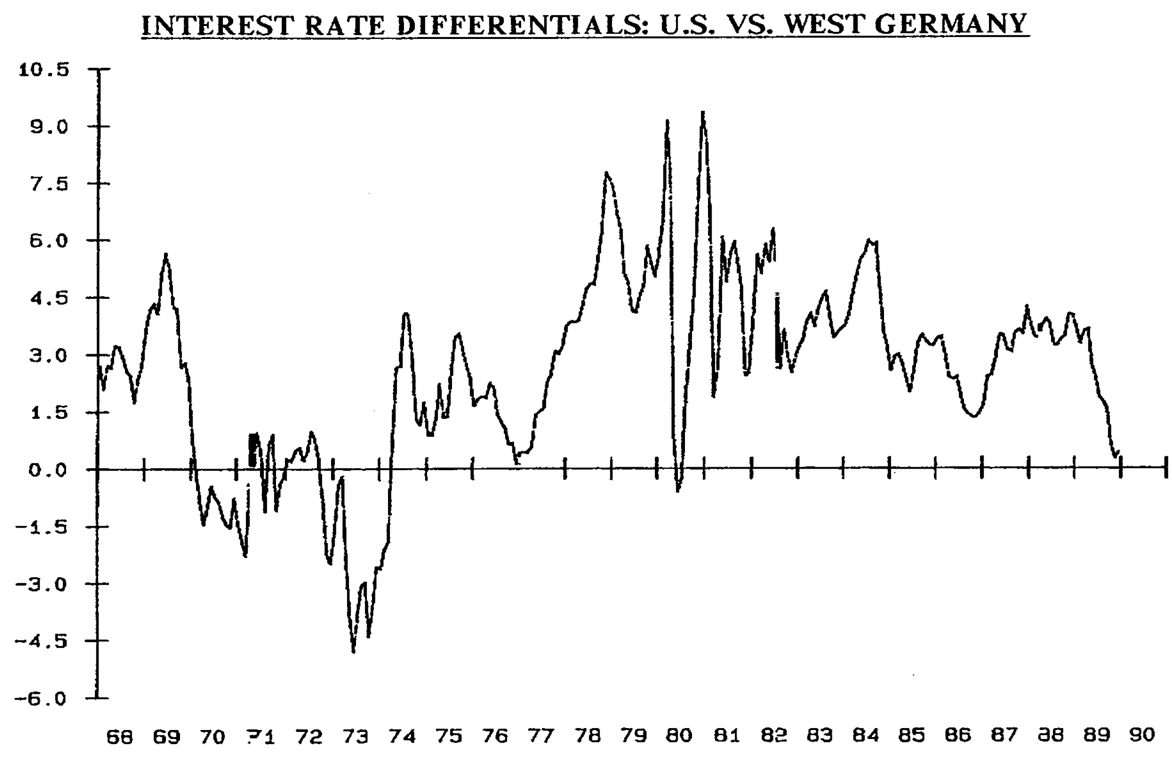
It is simply beyond our imagination how such a situation can continue to be balanced with U.S. interest rates below those of Germany and Europe in general. The central bank of a country with a large external deficit is always free to tighten but never free to ease without constraint. Having entered the 1990s under such conditions, market participants in the deficit countries should keep the painful asymmetry of that rule in mind.

KEY DETERMINANTS FOR THE DOLLAR TREND ARE THREE

How far can the dollar fall? Rather than just trying our luck with a rash projection, let's take a look at the main determinants of exchange rate movements. Traditionally, we have always looked to the following three factors.

1. Relative monetary conditions and changes in interest rate differentials;
2. Cyclical divergencies;
3. Relative growth potentials and economic dynamism.

Some readers may be quick to notice that our list of exchange rate determinants fails to mention the favourite of dollar bulls: purchasing power parity. We haven't omitted this popular argument by accident. As outlined in the last letter, the importance of the purchasing power parity theory (PPP) has been vastly overstated. What do these price indexes tell us about the difference between a BMW and a Chevrolet? Not very much. Neither is the competitive strength of a country a simple matter of cheap labour. Both Germany and Japan owe their superior export performance to their capacity to deliver the high-quality products that a prosperous world economy wants. Prices have only been a complimentary consideration in that success.



SOURCE: Schröder Münchmeyer Hengst & Co.

The Role of Relative Monetary Conditions. Relative monetary conditions and changes in interest rate differentials rank first in our list of three exchange rate determinants. The influence of these conditions are most important over the short run and work through two primary channels. The first of these depends on the sheer strength of credit demand relative to domestic supply as determined by monetary policy. Strong U.S. credit demand during a period of tight money - as experienced pronouncedly in 1983-84 - is conducive to a strong dollar.

By that standard, today's mix of sharply reduced U.S. credit demand and easier money is the recipe for a weak dollar. And interest rate differentials, as we have already reviewed, are at their worst since the mid-1970s.

Comparative Dynamism Eroding For America. . . The dollar/D-Mark exchange rate has always proven sensitive to changing market perceptions of underlying economic policies and long-run growth prospects for each of the respective countries. From this perspective, two key-words of the 1980s sufficed to highlight the prevailing bias: *Reaganomics* and

Euro-sclerosis.

The U.S. dollar trend of past years was attributable to more than just an cyclical upswing of interest rates. The added charismatic charms of Reaganomics was no small help. A strong market opinion developed that the steep rise of U.S. interest rates was merely a promising sign of economic strength - that being the result of superior economic dynamism and profitability on capital. That same line of thinking, therefore, also deduced that the large capital inflows financing the U.S. miracle could be continued indefinitely.

. . . And Catching Up to Reality For Europe. In sharp counterpoise to this image of effervescent capitalism was the drab image of a Europe fettered by lacklustre growth and sclerotic economies. In the gloom of a downturn and high unemployment levels, investors came to view the European economy as one without vitality. In that perception, lower interest rates were seen as a requirement rather than a virtue in order to stimulate employment and growth.

EUROPE AND AMERICA: CHANGING PLACES

Apparently, much of this cobwebbed thinking that diminishes Europe is still widespread, gauging from the persistence of "pro-dollar sentiment". Nevertheless, reality has already forged far ahead of those calcified perceptions. In fact, Europe and the United States have swapped roles as far as future growth prospects are concerned.

It is Western Europe - in particular the leading European economy, West Germany - that enters the 1990s with a new dynamism. In contrast, America limps into the new decade hobbled by the lowest growth potential of the entire post-war period. And it does so with an extremely vulnerable and fragile financial system.

Europe's Hard Road to Advantage. Most economies of Continental Europe are in their best condition since at least the 1960s. Few realize how much some European countries have done to bring their economies back to a higher long-term growth plane. Government spending and budget deficits (as a percentage of GNP) were reduced to raise savings and make room for higher private investment. At the same time, moderate wage increases in comparison to productivity growth helped raise rates of return on physical investment over the rate of return that could be earned on financial assets.

One is tempted to make the observation that while America and others only experienced the official rhetoric of supply-side economics, it was Europe that saw the actual implementation of supply-side policies.

Different Locomotives Drive the European and North American Economies. The result of the European policy mix during the second half of the 1980s . . . to make a generalization . . . was a transition to investment-led growth. Investment in manufacturing equipment began to increase considerably in 1985. Since then, the strong momentum in equipment investment has been maintained except for a brief sputter in 1986, when uncertainties surrounding the steep fall of the U.S. dollar intervened. The resulting change from export-led growth to domestic-driven growth required production restructuring.

The probability that the current European investment boom will continue in the medium term is very high. Even with capacity utilization in Europe (generally) at the highest levels since the previous cyclical peak of 1979, profitability on new investment has sharply improved simultaneously. Investment as a share of GNP continues on a rising trend.

LONG-TERM GROWTH CAPABILITY OF THE U.S. IS LIMITED

The contrast between the European and U.S. pattern of economic growth is as disparate as night and day, particularly so in terms of long-term consequences. America bought the cheap thrill of a debt-driven consumption boom at the onerous cost of under-investment. A swelling trade deficit reflected a collapsing savings structure all of which then undermined the future growth potential that lay dependent on new investment.

The gradual impairment of the U.S. economy's supply-side by anaemic under-investment has been visible to the careful observer all along. However, there were a number of superficial illusions that baited the fancy of optimists. For example, strong labour force and employment growth kicked sand in the eyes of many observers.

Changing Labour Supply Conditions... U.S. employment grew by a staggering annual 2.9% between early 1986 and 1989. Overlooked was the fact that an overwhelming share of employment growth occurred in low-paid, low-productivity jobs within consumer-related service sectors. As such, strong job growth did bolster U.S. GNP and helped create the illusory image of economic dynamism.

As we enter the 1990s, a critical new fact is that these sizable contributions from work force growth are over with. Changing demographics have now tightened labour supply growth to about 1.5% a year.

. . . And Productivity Constraints Limit Growth Ceiling. In the meantime, potential for productivity growth remain as poor as ever. A growth rate of 1% might be attainable at best and taken together with flagging labour supply, implies a long-term growth limit of little more than 2.5% a year for the U.S.. Such a growth ceiling would be the lowest among the industrialized nations. Neither policy makers nor markets seem prepared for such sluggish long-term growth.

A point we need to stress is this: both developments of a weakening U.S. economy and the strengthening of the European economy are not just simple cyclical symptoms. These two trends are also the recompense of much greater structural causes. Recent economic polarity is the early tremor of deep secular changes in the future growth potential of the two continents: highly positive for Europe and extremely negative for the United States.

EASTERN EUROPE: ANOTHER POSITIVE ACCENTUATION. . .

Now, on top of the favourable economic contrast we outlined for Europe, comes the opening of Eastern Europe. As markets have already begun to realize, the opening of the East-bloc is sure to add to Europe's new dynamism over the long run. These dramatic political events have helped to draw attention to the fruits of Europe's long-running comeback.

. . . FOR A STRONG DEUTSCHE MARK.

Earlier, we enumerated three main determinants for the dollar/D-Mark exchange rate: relative monetary conditions and interest rate differentials, cyclical divergencies and changing perceptions of long-run growth dynamics. We have to say that all of these short and long-term fundamentals have not been so favourable to the D-mark for a long, long time. In fact, we're even inclined to believe that conditions for the D-Mark are even more favourable than in 1985/87 when the dollar fell to a low of DM 1.57. During those years, the economic recovery in Europe was still rather fragile and German interest rates never reached U.S. levels.

This time, German interest rates are already partly higher than U.S. levels. Whether German interest rates rise or not, they are at least not likely to fall over the foreseeable

future. Conversely, a weakening U.S. economy may compel the Fed to ease further.

U.S. INVESTMENT MARKETS LOSING ALLURE

In 1985/87 extremely bullish U.S. bond and stock markets offered maximum attraction in term of yields and capital gains. Yet, despite these benefits, the dollar fell. This time, U.S. bonds and stocks lack the benefit of any strong attraction, either in yield or in terms of prospective capital gains. Given all the negatives we've enumerated, one can only wonder what continues to pull foreign dollar-buyers.

Only Fleeting Issues of Psychology Support U.S. Dollar. In our view, there are three main props that still support the dollar: first, jittery suspicions about Mr. Gorbachev - a relic of the famous "safe haven" theory; second, a widespread perception that the U.S. economy has hit bottom and should soon rebound with rising interest rates; and third, the myth that U.S. assets are cheap.

Apart from the "Gorbachev jitters", the key question for the exchange markets is whether or not the optimistic assumption of a recession avoidance and continued growth will prove right. Looking at the different demand components, it is difficult to justify any growth at all, except that contributed by short-term inventory expansion. For the first time since 1982, all sectors of the economy - including exports, business investment, construction, government spending and private consumption - look set to remain flat or weaken further.

DOWN TO A FEW WEAK DEFENCES

Most observers cling to one remaining life raft: the hope that the Fed's past monetary easing has been sufficient to avoid a mild recession. Though we find it hard to believe, the "soft landing dream" is still pre-occupying markets.

In reality, as we have explained many times, the Fed is confronted with unprecedented conflicts in policy requirements that make fine-tuning more difficult than ever before. The relatively high interest rates abroad, the weak dollar and an inflation rate that holds stubbornly at 4.5%, force a bias to err on the side of monetary tightness. On the other hand, exorbitant debt levels and the unmitigated mess in the financial system, recommend a policy that cannot be easy enough.

In our view, the more immediate pressure for the Fed is overwhelmingly in favour of utmost caution. But that course of action is also bound to increase the probability of a recession.

Isn't There a Way Out? Only Quick Fixes and Painful Longterm Solutions Left. Is there still a realistic chance that an optimistic scenario could still be vindicated? The key question is whether a minor further weakening of the economy subdues inflation and allows a rebound in mid-1990.

Although the consensus growth expectation for the U.S. economy is already quite subdued for the 1990 year, we still find it difficult to support these forecasts with any justifiable set of demand components. Many economists have already written off prospects for export growth and business investment. U.S. exports reached a peak of $31.3 billion in June 1989 and have been struggling to regain that level ever since. And given the ensuing sharp declines in business cash flow and profits, it is also unrealistic to make a case for higher business investment.

Given that set of parameters, it might be guessed upon which factor the "no-recession" advocates pin their hopes - what else but consumer spending that is expected to again ride to the rescue. However, we have two objections to that scenario.

First, we doubt that the consumer is able to prime the economy's pump for very much longer than a temporary spurt; and second, this "soft landing" concept is the exact opposite of the necessary antidote for America's imbalances. A true soft landing would require that rising exports take up the slack from moderating domestic demand. That would allow America to switch production to exports; and not to consumption. And, if such a transition isn't possible or encouraged while the rest of the world is booming, when can it ever be achieved? Without a strong revival in exports, the risks for the U.S. economy are distinctly dishevelling.

Just How Shoddy is the Ship?. . .Profits Are Leaking. Efforts to keep the U.S. ship afloat are competing against time and ever larger leaks in the superstructure. There's a deluge of life-threatening seawater everywhere. Corporate America has entered the 1990s with the lowest profit margins ever recorded . . . a situation which doesn't nicely complement the all-time high debt levels. After-tax profits have fallen from a peak of $175.6 billion in the fourth quarter of 1988 to $152.4 billion in the third quarter of 1989. That's hardly higher than the $152.3 billion recorded in the recession year of 1980.

. . . Real Estate is Tipping. Real estate is in the first stage of a recession and is already pock-marked with sharp price declines in many regions. Falling house prices are bound to aggravate a cyclical downturn. Home equity accounts for more than 40% of household net worth and has been a major source of consumer confidence. The "wealth effect" of rising home equity is sure to have been grease on the slide to over-consumption. Declining home values will cause financial trouble. Consider that the average downpayment of the first-time home-buyer last year was only 14.6% of the purchase value as compared to 20.4% in 1987.

. . . The Whole Financial System is Waterlogged. Thrifts, banks, and insurance companies are in a mess. Every third thrift is bankrupt and has to be bailed out by the government. Commercial banks are staggering from one problem loan area to the next. Even though loan losses on foreign loans that were initiated as much as a decade ago are still rising to the surface, now comes the effluent of bad LBOs ($150 billion), industrial and commercial property loans of $350 billion (much of it with vacancy rates of 20-30% and more). By far, the financial system's biggest bet rides on mortgages which represent total assets of $2.8 trillion.

. . . WITH LITTLE HELP FROM AN OLD FRIEND: JAPAN

Speaking of America's vulnerabilities we can't overlook what might be the most formidable of all: the Japanese threat. In our last letter, we pointed out that the performance of the U.S. dollar and bond market is interrelated and tightly linked to Tokyo. These markets are strong if the Japanese buy and are weak when the Japanese sell. If Yen-based investors should decide to sell all three including stocks - U.S. financial markets would collapse.

Recently, the London Economist carried an article "Thank you, Japan. . .". Japan has used its Herculean financial power to extraordinary effect. Japanese liquidity has been one of the main sources of stability for the world economy in the 1980s.

It is a strange notion to contemplate that the Japanese have had a stabilizing effect with their persistent monetary laxity. Yet, the trouble with that laxity is that it has come with the gnawing side-effect of the world's most fearful excesses in property and bond prices. These may be the seeds of an eventual bust. How would that affect capital flows into the United States? It could well be that it is precisely that concern that's causing the Bank of Japan's hesitancy to tighten more aggressively. That procrastination, however, is self-defeating because it always results in a loss of credibility and all-around control.

SUMMARY CONCLUSIONS

As we have often stressed, America's problems are not simply cyclical but also structural. Years of overconsumption, undersaving, underinvestment and widespread overindebtedness have gravely weakened the defence system of the U.S. economy. As an AIDs patient can fall victim to minor opportunistic diseases so can the American economy fall prey to "the minor straws that break the camels back".

Surely, America stands at a critical threshold. Can that point be very far when the smoke of "never-say-die" optimism finally blows away to reveal the jagged teeth of the economic and financial instabilities that have been lurking and building all along.

The period most critical for the economy, the dollar and the financial markets will start when the conflicts between policy requirements become more pressing. That will happen when a recession arises against a backdrop of stubbornly high inflation and a weak, (probably falling) dollar. In that kind of scenario how can the Fed be expected to act?

The Fed is certain to come under increasing pressure to ease. The Fed may resist, but we even doubt that such a show of determination would be enough to stabilize the dollar. Once confidence has been shattered, foreign investors will demand higher and higher interest premiums.

Once the decline gathers momentum, the stage will be set for what politely used to be called a "stabilization crisis". Only this time, foreign capital flows will be taken hostage with mammoth currency losses. That mechanism will promptly deliver an "illiquidity shock" in very short order as the required capital inflows to offset the U.S. external deficit screech to a trickle.

When such a crisis erupts the Federal Reserve will have no alternative but to raise interest rates. The trouble with that motive, though, is that high interest rates then project an image of weakness and desperation.

High interest rates will no longer be seen as a reason for strength and risk-free returns. Once the bandwagon gains momentum, even sharp rises in interest rates may do very little to stem capital flight. And, as goes the currency so go the highly liquid foreign investments in bonds and stocks.

While high interest rates will be fully justifiable in the realm of capital flows, the side-effect for the real economy will be devastating. Financial markets will be bludgeoned with two clubs: the illiquidity caused by the vacuum of capital outflows and the waning fundamentals of a weakening economy.

Publisher: Dr. Kurt Richebächer
Muehlegasse 33, CH-8001 Zuerich, Switzerland
Editor: Hahn Capital Partners

Annual Subscription:
SFr. 600.–/US-Dollar 400.– for subscribers outside Europe.

Languages: German/English